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More Flexible Investment Guidelines for the European Patent Office

Samuel Adams (Müller-Boré & Partner) · Wednesday, January 31st, 2018

Recently, "New Investment Guidelines of the European Patent Office" (CA/F 18/17 Rev. 1) was published among the "Administrative Council documents" on the EPO web site.

The Investment Guidelines relate to management of the treasury of the EPO and outline a more flexible approach for investing the funds in the treasury. In particular, rather than being limited to fixed income bonds and income bearing securities, as in the replaced Guidelines (CA/F 11/15), the EPO will be allowed to invest according to a more flexible strategy. In principle, this sounds sensible. However, the Investment Guidelines include the following disconcerting text:

2. The EPO shall determine ex-ante the investment strategy of the funds by means of a Strategic Asset Allocation (SAA), and by setting benchmarks. In that framework, the asset classes listed here below shall be available, both for long and short positions, within the maximal ceiling specified for each of them as follows:

a) Equities – Up to 40% of the total portfolio

b) Fixed Income – Up to 60% of the total portfolio

c) Cash – Up to 10 % of the total portfolio

d) Commodities – Up to 5% of the total portfolio

e) Real Estate – Up to 15% of the total portfolio

f) Alternatives / Multi-Asset Investments – Up to 15% of the total portfolio

<u>To execute the investments in the above asset classes the EPO is allowed to use all appropriate financial instruments</u> such as:

– The usual financial instruments: listed or non-listed shares (Private Equity), bonds, loans including high yield loans;

***– Currencies**;*

***– Derivative instruments** like options, forward, futures, swaps, debts, convertible bonds;*

– Structured and custom finance products including securitized and ***collateralized debt instruments*** *(i.e. Asset Backed Securities ABS,* ***Mortgage Backed Securities*** *MBS,* ***Credit Default Swaps*** *CDS) and other hybrid instruments combining elements of other asset classes or underlyings such as inflation;*

– Collective Investments as UCITS Funds or Alternative Investment Funds AIF (hedge funds).

(CA/F 18/17 Rev. 1, p. 13, emphasis added)

The text above is disconcerting because it could allow the EPO to go too far. While some limited equity investment seems advisable in view of painfully low interest rates that are likely to be part of our reality for the foreseeable future, the range of exotic "financial instruments" made available by this provision appears to be unnecessarily extensive. Less than two years ago, Warren Buffet warned that derivatives can "get so complicated that they're very hard to evaluate" and described them as "weapons of mass destruction" (see http://www.telegraph.co.uk/business/2016/05/01/warren-buffett-issues-a-fresh-warning-about-derivatives-timebomb/). In turn, collateralized debt instruments (often referred to as collateralized debt obligations) arguably helped lead to the 2007-2008 financial crisis (see e.g., http://www.nytimes.com/2007/07/02/opinion/02krugman.html, https://www.amazon.com/Big-Short-Inside-Doomsday-Machine/dp/0393338827). It is not clear that the regulations imposed after the financial crisis fixed all the problems with complex financial instruments, such as structured debt, particularly with regard to the accountability of the rating agencies in assessing the associated risk (see e.g., http://knowledge.wharton.upenn.edu/article/cdos-are-back-will-they-lead-to-another-financial-crisis/).

In the end, it is questionable whether so much investment freedom, along with the inevitably associated risk, is the appropriate response to low interest rates. It would seem that a gradual introduction of equity investment, possibly limited to selected index funds (e.g., Exchange-Traded Funds) and definitely tempered by reasonable restrictions, would be a safer approach. Further flexibility could be introduced later, if necessary.

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